IN THE SUPREME COURT OF

THE UNITED STATES

OCTOBER TERM, 1973

NOS. 72-1490,-1491

FEDERAL POWER COMMISSION, PETITIONER

v.

TEXACO INC., ET AL.

DUDLEY T. DOUGHERTY, ET AL.,
CO-EXECUTORS OF THE ESTATE OF
MRS. JAMES R. DOUGHERTY, ET AL.,
PETITIONERS

v.

TEXACO INC., ET AL.

ON WRITS OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA

REPLY BRIEF OF DUDLEY T. DOUGHERTY,
ET AL.

Respondents attack Order No. 428's scheme of regulation as concerns both flowing gas rates and new gas rates. As to existing sales of flowing gas--gas which was subject to Federal Power Commission jurisdiction at the inception of Order No. 428--it is argued that the order provides no rate regulation of any kind, and hence abrogates the requirement of the Natural Gas Act that the Commission regulate rates of all gas sales. The large producers contend that they are discriminated against in permitting the small producers to collect their contract prices. As to new contracts for flowing gas and as to all new gas, it is argued that the Commission's reliance on variable market criteria is an abdication of its statutory responsibility to insure just and reasonable rates.

1. Contrary to the assertions of several respondents, Order No. 428 does not free all flowing gas sales by small producers from price regulation. Approximately 73.5% of the flowing gas sold by small producers on January 1, 1974, was sold at or below the just and reasonable area rate set by the Commission for such sales.1/ This includes gas (62%) which has been dedicated pursuant to contracts in which the contract rates--which fix the highest price the small producer will

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1/ Foster Associates, Inc., The Impact of Deregulation on Natural Gas Prices, p. 4 (August 1973).

be paid--are below area maxima. It also includes gas (8.6%) sold at prices determined pursuant to spiral escalation clauses, and Order No. 428 limits the rates resulting from such clauses to the appropriate area rate. And it includes gas (2.9%) sold pursuant to expired contracts, which can be sold only at the contract rate unless the Commission approves the small producer abandoning the sale or unless the old purchaser agrees to pay a higher price.2/

Thus, the small producers can receive a rate in excess of the applicable area rate set by the Commission for only approximately 26.5% of the gas presently covered by small producer contracts. Order No. 428 therefore will not result in increases above

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2/ The assertion by PSCNY (Brief at p. 44) that the small producer will be able to obtain the highest large producer or prevailing intrastate market prices when a contract expires is in error. There can be no abandonment of the dedication with the old purchaser unless the Commission approves. See App. 141 n. 4. And the practical effect of the small producer's right to try to renegotiate a higher price with the old purchaser is minimal, since the purchaser knows that unless there is an abandonment the most he will have to pay is the applicable area rate and thus he has no reason to accept a higher price than this. See Dougherty, et al. Brief at p. 22.

applicable area rates in the price paid small producers for all their share of the total interstate sales of natural gas (about 11%). To the contrary, it may result in an increase in the price above those rates for only the 26.5% of small producer gas for which prices can be increased, or about 3% of total interstate sales.

It is the potential increased rates for this 3% share that the Commission determined was just and reasonable, having balanced the need of the consumer for greatly increased supplies of gas at the minimum price necessary to elicit such supplies against the small producer's need for a secure source of exploratory funds in order to furnish such supplies. While there is, to our knowledge, no statistical data available to quantify the impact that increased prices for this fraction of total interstate gas sales might have, the Commission, with whom all small producer contracts are on file, has determined that the impact will be de minimis. To overturn this determination, as respondents urge, on the ground that the Commission did not explain the impact, presupposes that the rate examinations undertaken in the multiple area rate proceedings have not developed ample evidence to

establish this fact.3/

2. The large producer respondents point out that they have entered into contracts to sell gas to their purchasers at a price less than the contract price at which they have agreed to purchase such gas from small producers. They argue that Rule No. 428, by entitling small producers to collect their contract prices, will result in the large producers paying more for such gas than they are entitled to receive upon selling it, and that the Commission's refusal to permit the large producers to pass on this increased cost to their customers improperly discriminates against them.

3/ The small producers presented ample testimony during the course of this proceeding establishing their important exploratory function in the industry and their need and reliance on flowing gas revenues for drilling funds. Respondent Tenneco, Inc. (Brief p. 45) characterizes this testimony as self-serving. The proceedings before the Commission offered adequate opportunity for Respondent Tenneco to ventilate any conflicting opinions, which it chose not to do. See Phillips Petroleum Co. v. Federal Power Commission, 475 F.2d 842, 850 (10th Cir. 1973), certiorari denied sub nom. Chevron Oil Co. v. Federal Power Commission, 42 U.S.L.W. 3406 (Jan. 14, 1974).

The Commission invited (App. 240) the large producers during the course of this proceeding to make the appropriate proof under Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348 (1956), to show that they should be granted relief from their sales contract price limitations. The large producers failed to make such a showing. This avenue is still available to the large producers for relief, if they choose to pursue it.4/ Until they have exhausted their available remedies, they should not be heard to complain about asserted discrimination that is solely attributable to their willingness to contract to pay prices to small producers which they never intended to pay.

3. Respondents also contend that with respect to new gas the Commission is powerless to depart from the traditional rate base approach and to suggest two market criteria which it will

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4/ The large producers' position on this point (see Phillips Petroleum Company Brief, pp. 35-36) demonstrates the effectiveness of Order No. 428's indirect regulatory scheme. The point is made that the large producer or pipeline *could* negotiate the best possible price with the small producer, but that since all well-head sales have been directly regulated and the price set by the Commission, there has until now been no incentive to do so. Order No. 428, of course, is intended to provide this incentive.

consider in reviewing small producer rates in pipeline rate or tracking proceedings. In Federal Power Commission v. Sunray DX Oil Co., 391 U.S. 9, 25-26 (1968), however, this Court suggested that the variable market price, if it is the "true" market price, would also be the just and reasonable price required under the Act. If, as under Order No. 428, the purchasing pipelines are not freely permitted to pass through their purchased gas costs, but instead are provided an incentive to bargain and hold prices down, the market price resulting from this arrangement reasonably can be expected to achieve the "true" market price which the Court characterized in Sunray as just and reasonable.5/

5/ Indeed, the basic reason that this Court disapproved the Commission relying on contract prices in setting initial rates was that no incentive existed for gas purchasers to bargain hard for low prices. See Atlantic Refining Company v. Public Service Commission (CATCO), 360 U.S. 378 (1959). Mr. Justice Harlan explained the CATCO decision in the Sunray case (391 U.S. at pp. 25-26):

> *** [T]here can be no assurance that an initial price arrived at by the Commission [based on field prices] will bear any particular relationship to the just and reasonable rate. Any such assurance would necessarily

Of course, bargaining incentives are fundamental to the indirect regulatory system established under Order No. 428. As is manifest from the outcry of the large producer and pipeline purchasers, new and significant responsibilities are being imposed on them. Prior to Order No. 428, these respondents could contract to purchase gas without any obligation to exercise circumspection or even good business judgment as concerns the rates which they agreed, contractually, to pay. These

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5/ Continued

> be based on a belief that the current contract prices in an area approximate closely the "true" market price--the just and reasonable rate. Although there is doubtless some relationship, and some economists have argued that it is intimate, such a belief would contradict the basic assumption that has caused natural gas production to be subjected to regulation and which must have underlain this Court's CATCO decision--namely, that the purchasing pipeline, whose cost of purchase is a current operating expense which the pipeline is entitled to pass on to its customers as part of its rates, lacks sufficient incentive to bargain prices down. (Emphasis added.)

respondents no longer may contract <u>in vacuo</u> concerning rates, for Order No. 428 is the renaissance of viable market forces in the gas producing industry. The Commission's reliance on market forces and the prices resulting in the carefully structured market which Order No. 428 is designed to achieve is no abdication of its regulatory function.

Respondents point out that competition is intense for the short supply of existing gas, and argue that as a result their bargaining powers are curtailed. Gas supplies are indeed limited. But the bargaining burden imposed under Order No. 428 falls equally upon all members of each class of purchaser (large producers and pipelines), and there is no discrimination among members of the same class of purchaser. The small producer sales market is monopsonistic, and absent a pipeline connection their gas is not sold. Due to the inability of the small producer to withhold his product from the market (see Dougherty, et al. Brief, at pp. 24-25), the bargaining power of these purchasers remains paramount and is being exercised effectively to reduce contract rates.

The assertion that it is impermissible for the Commission to impose upon purchasers the duty to bargain for gas because the Commission has heretofore directly set rates is not supportable. This Court in <u>Sunray</u> (391 U.S. at 47-52) sustained the Commission's decision to require

pipelines, rather than the producers, to establish public convenience and necessity for the sale of the gas involved there. Cf. Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621, 642-646 (1973). The Commission similarly can require that purchasers, rather than small producers, establish that prices paid for gas are just and reasonable.

The large producers argue that Order No. 428 discriminates against them by giving the small producer an unfair advantage in leasing opportunities. Small producers historically have not leased large tracts such as the large producers desire, with the concommittant large expenditures required, but instead have chosen to spend their funds in exploration. See Dougherty, et al. Brief, pp. 24-25. The large producers' leasing activities therefore are not really threatened under Order No. 428. To the extent there is competition between small producers and large producers for lease acreage and the small producers have additional funds available, by reason of Order No. 428, for this purpose, this advantage is justified by the significantly more intensive and extensive exploratory efforts of small producers, as compared to large producers. Compare Permian Basin Area Rate Cases, 390 U.S. 747, 784-86.

Since significant differences in conditions exist between large producers and small producers, it is within the Commission's discretion to

classify and treat them differently, and such discrimination can be both reasonable and lawful. See United States v. Wabash R. Co., 321 U.S. 403, 411 (1943). The record fully supports that the classification under Order No. 428 is reasonable and that the Commission's allocation of the regulatory burden is consistent with and justified by its responsibility to secure an adequate supply of gas.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed and the orders of the Federal Power Commission should be sustained.

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